STAFF STUDY: Inventory Pricing Policy

I. PROBLEM

Should CIA revise its inventory pricing policy to provide for reducing the carrying value of nonexpendable property due to depreciation and obsolescence.

II. DEFINITIONS

A. Nonexpendable property: Those items of property which have a relatively long life (several years) and are used repeatedly to furnish a series of services. Synonymous with "capital assets" or "fixed assets".

B. Depreciation: The use of nonexpendable property involves its wearing out or becoming exhausted. This wearing out or exhaustion usually is gradual, extending over a period of years, and is ordinarily called depreciation.

C. Obsolescence: The process of becoming obsolete due to progress of the arts and sciences, changed economic conditions, legislation, or otherwise, which results in a decrease in value and ultimate retirement of the property. In recent years, technological advances made by industry point out, as a factor in depreciation allowances, the importance of obsolescence resulting from those technological advances.

III. FACTS BEARING ON THE PROBLEM

A. Under CIA's inventory pricing policy, nonexpendable property is carried on our books and records at fixed prices. Fixed prices represent replacement costs based on an evaluation of prices paid for acquisitions during the previous fiscal year (see Tab A). Nonexpendable property placed in use is charged to the cost of operations at the appropriate fixed prices. No adjustments are made for depreciation or obsolescence.

B. The Department of Defense has a standard pricing policy (fixed prices) for all items of materiel for purposes of inventory accounting and the pricing of all sales or issues for any purpose (see Tab B). No adjustments are made for depreciation or obsolescence.

C. In isolated cases, some federal agencies carry fixed assets on their books and records at cost less depreciation reserves for purposes of determining net income. This practice is ordinarily limited to those cases wherein funding of the Agency's activities or a portion of the activities is accomplished from income produced by such activities; for example, Department of Interior, Bureau of Reclamation's agencies engaged in the production and sale to the public of electric power.

D. The majority of business enterprises organized for profit carry fixed assets or capital assets on their books and records at cost less an allowance for accumulated depreciation. The cost of operations is charged only for the amount of depreciation accrued during the accounting period.

E. The majority of philanthropic institutions or nonprofit enterprises record fixed assets at cost, and such items are charged immediately as an operating expense. Depreciation as an element of cost is not applicable to such philanthropic or nonprofit enterprises.

F. Within CIA the practice of pricing property placed in use on the basis of fixed carrying values is tied in very closely with the processes of budgeting for procurement allotments and allocation of requisitioning authority. Consideration of a change in pricing policy necessitates consideration of changes in procedure for budgeting and determining requisitioning authority for property.

G. One Agency field station has suggested that property placed in use be charged to the cost center of the using activity on the basis of a price adjusted for accumulated depreciation including a factor for obsolescence where appropriate. Such suggestion was apparently prompted by a belief that it is unfair to charge requisitioning authority and related cost center the same price for used or obsolete property (although in serviceable condition) as is charged for new property. One case has

been cited wherein a field station purchased new property rather than accept used property because of the belief that its requisitioning authority would be over charged if it accepted issuance of the used property at the fixed carrying value.

IV. DISCUSSION

A. The policy of carrying nonexpendable property at cost less depreciation is primarily limited to business enterprises organized for profit (or to income producing activities wherein it is necessary to determine and report net income or profit). The principal reason for this is the fact that the determination of the net profits of business enterprises ordinarily involves the process of matching all applicable costs against the corresponding income of a fiscal period. As a result, procedures have been evolved for the allocation of costs which should be applied currently and costs which should be deferred until the related revenue is attained. Thus, the consumption of capital assets represented by depreciation is an operating cost which must be deducted from the related revenues of a fiscal period for the purpose of determining the net income for that period. Also, since business enterprises must pay Federal Income Taxes on net income, the Internal Revenue Code contains specific provisions relating to capital expenditures and depreciation. (Ordinarily the code requires depreciation of fixed assets over the useful life of the assets.)

B. Philanthropic institutions and federal agencies (except for isolated cases mentioned in paragraph III.C.) do not make profits. They are not subject to taxation. The procedures set up for the determination of business net income, therefore, do not necessarily apply. There is no necessity for differentiating between the expired and deferred portion of any expenditure. The fact that depreciation is an element of cost which affects net income in business enterprises does not apply to philanthropic institutions and federal agencies. Further, in respect to federal agencies, funds are ordinarily appropriated by Congress to finance the objectives and program outlined in the approved budget for a fiscal year only. Reasonable amounts budgeted for fixed assets are recognized as necessary for furtherance of the program, and these items must be accounted for as an expenditure of the year in which they are obligated. There is no assurance that there will be a repetition or continuity of fund appropriations. The annual accounting period is not only logical but mandatory.

Hence, the policy of depreciating fixed assets as established by business enterprises is not pertinent to federal agencies.

C. The principal advantages to be gained from pricing our non-expendable property at cost less accumulated depreciation are as follows:

1. The net worth of the Agency would be more accurately stated.

2. The cost of operations would more nearly represent actual cost, and requisitioning authority would be charged for property placed in use in an amount more nearly representing actual value of the property, thereby encouraging operating officials to accept used property in lieu of new property.

D. The above advantages of carrying property at cost less depreciation should be weighed against the following disadvantages which would result from discontinuing the standard pricing policy now used:

1. One of the objectives of the Agency is to perform its assigned mission at the lowest possible cost. Changing our inventory pricing policy to provide for depreciation and obsolescence would increase costs substantially. For example, assume that we have purchased ten recorders which were shipped at the same time but having been purchased at varying prices. Under our present system, the ten recorders would be recorded on a single inventory card as one line item at a fixed unit price. Issues, returns, and reissues may be recorded on the same card and priced at the same standard price. A system requiring pricing at cost less depreciation would require a separate inventory card for each recorder if prices varied or ten inventory cards. Upon issue, depreciation would have to be calculated and deducted from cost to arrive at book value or value to be charged the using activity. Returns and reissues would require an analysis of condition; an estimate of remaining usefulness; the setting of the relative value compared to a new item; and adjustments to inventory records, asset and cost accounts. Adoption of the policy of pricing property at cost less depreciation could conceivably increase our workload tenfold in the example cited, resulting in a substantial increase in over-all costs of operations.

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2. Although the net worth of the Agency would be more accurately stated under the cost less depreciation pricing policy, the value of such information to management is doubtful. In fact, management would probably be more concerned with the estimated replacement cost of property placed in use than an accurate statement of the net worth. This is true because our budget for the next fiscal year must include an amount sufficient to cover necessary replacements of property in use. Determination of replacement costs under a cost less depreciation pricing system would be difficult, whereas the use of fixed prices greatly facilitates such a determination.

3. Although the cost of operations and requisitioning authority would benefit if issues of nonexpendable property were charged at cost less depreciation, the following disadvantages would still prevail:

a. The charge to the cost of operations would not represent "actual" cost as the property would have residual value at the end of the fiscal year. A more accurate charge to cost of operations would result if we charged the using activity only for the amount of depreciation applicable to the period in use. However, this would also result in a residual or undepreciated value of the property at the end of the fiscal year which should be charged to costs (in the form of depreciation) of the succeeding fiscal year(s). There is no assurance that we would receive an appropriation of funds to cover such costs in succeeding fiscal years. In fact, Congress would not approve an increase in the budget to cover depreciation on property purchased from funds appropriated in prior years.

b. A charge to requisitioning authority based on cost less depreciation would encourage using activities to accept used property but would create another problem in controlling funds. Requisitioning authority and procurement allotments are established on the basis of standard prices (replacement costs) of the property involved. To charge out the property issued at a price less than the standard price would serve to augment the

using activity's requisitioning authority by building up a "hidden reserve" in the amount of the difference between the standard price and the reduced price based on depreciation. Thus, the entire budgeting process for property would have to be changed to permit pricing of property issues at cost less depreciation. Such a change would increase our workload substantially and make the budgeting process extremely difficult if not impracticable. For example, an operating official involved in budgeting for his operations may be able to determine the property that must be replaced and the additional property that will be required, but how will these property items be priced to arrive at the amount to be included in the budget? Under a "cost less depreciation" system of inventory pricing, he would first have to determine what used property would be available for issue during the next year and whether or not such used property would be available at the time it was needed. Since the availability of used property is to a large extent contingent upon "turn-ins" by other activities, this would be a most difficult if not impracticable task. Also, if it were possible to determine the availability of used property, the pricing of some would be almost an impossible task as the projected condition of the property, accumulated depreciation to date of issue, obsolescence, etc., would have to be ascertained.

D. Some of the advantages of our present inventory pricing policy which would not be found in a cost less depreciation pricing system are:

1. Values of inventories are more easily maintained by using standard pricing procedures and are more closely related to current replacement costs.

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3. The selection of items to be made available for immediate issue from stock and the standardization of other procured items would not have been possible without the use of definite standard

prices. Allocation of items and funds would have been wholly impracticable using a variable, fluctuating, depreciation pricing system.

4. Standard pricing of supplies and equipment provides advantages over other inventory pricing methods in promoting uniformity, accuracy, and simplicity in both accounting and inventory control functions.

5. The preparation of budget estimates is greatly facilitated by standard pricing.

E. Some questions raised relative to the charging of property issues to requisitioning authority may have resulted from misunderstanding of the purpose and objective of the requisitioning authorizations (see paragraph III.G. above). The purpose of requisitioning authority is to provide specific authority by using components to draw property consistent with their budgeted property requirements based upon the cost of necessary replacements from procurement allotments. When property drawn has been determined excess to Agency needs, it can be issued without charge against the component's requisitioning authorities.

V. CONCLUSION

A. The relatively minor advantages of a cost less depreciation basis for inventory pricing are greatly outweighed by the disadvantages. Therefore, the Agency should not revise its inventory pricing policy.

B. The Office of Logistics (Supply Division) will continue to revise its fixed prices for specific items when unusual circumstances (such as current stock positions and acquisitions from other agencies at no cost or at reduced prices) warrant such adjustments. The prudent application of this principle will furnish operating elements with desired materiel at revised fixed prices which are more realistic than the previously established fixed prices based on original acquisition cost.

VI. ACTION RECOMMENDED

Continue the existing practice of carrying and issuing property at standard fixed prices for Agency property accounting purposes.